national capital markets. Its ability to raise capital at relatively favorable rates has enabled it to become the dominant institutional lender for agricultural real estate. Its dominance of this market, and the disruptions that would occur in the sector if it were to fail, are primary arguments for coming to the aid of the FCS. If other lenders increased the degree of competition in this market, there might be less need for Congressional intervention in the future.

Some of the proposed changes in the FCS's organization may not be mutually compatible. For example, efforts to increase local control may work at cross purposes with those aimed at improving the system's ability to deliver credit efficiently. There may also be a contradiction between reorganization and the overarching goal of minimizing the cost of assisting the FCS. Specifically, efforts to enhance the competitive position of non-FCS lenders in the real estate market could increase the cost of seeing the system through its financial problems.

Borrowers' Rights

In addition to the concerns about the distribution of power within the FCS, many people are worried about the relationship between the FCS and its borrowers. This concern stems in part from the disruptions in rural areas brought on by the recent downturn in the farm economy. The most potent symbol of that downturn is the farm auction following a foreclosure. Completion of a foreclosure generally results in the farm family losing its home as well as its business. The disruptions of a foreclosure for the farm family and for rural communities are considerable. Efforts to enhance borrowers' rights are aimed at making foreclosures a last resort in dealing with farm financial problems, and at minimizing the consequences of foreclosures that do occur.

Another aspect of the borrowers' rights debate focuses on how the burden of losses should be shared. The causes of the downturn in the farm economy are many and include factors internal to the farm economy (overexpansion by some farmers, an inflexible government agricultural policy, increased productivity) and several outside of it (changes in monetary policy, changes in trade policies, better-than-average weather in major producing areas). The financial consequences of the downturn are being shared by the government (through record-high farm program costs), lenders (through unprecedented losses and numerous bank closures), and farmers (through higher farm foreclosures). The campaign for borrowers' rights can be seen as a political judgment that the FCS should shoulder more of the adjustment costs.

The equity of borrowers' rights must be questioned. First, is it equitable to grant rights to those borrowing from the FCS while remaining silent vis a vis the rights of other private-sector borrowers? Second, is it equitable to redefine the terms of a contract between the FCS and a borrower after the contract has been signed and acted upon? Third, is it equitable to provide benefits to FCS borrowers who have not remained current on their loans while borrowers who do meet the terms of their contracts receive none?

Assistance for the FCS

While there is strong sentiment in favor of assisting the FCS, opinions differ as to how much assistance may be needed, when federal money should start flowing to the FCS, the form this aid should take, and the institutional safeguards that should be employed to ensure that federal assistance is used wisely. This debate has two major components. One focuses on the policy aspects of FCS assistance, the other on the budgetary aspects.

Policy Aspects of FCS Assistance. Important issues of policy relate to how much federal assistance should be given to the FCS, what form that assistance should take, and when and how it should be given. The basic trade-off is between accountability and flexibility. The issues involved can best be illustrated by extreme examples. Flexibility would be maximized if the government simply gave the FCS unrestricted access to U.S. Treasury borrowing. The FCS would be free to make such changes in its structure and operating procedures as it saw fit, and could use the federal money to cover existing bad debt. This would give the FCS little incentive to find the least-cost solutions, and the government would have no leverage in demanding changes in the system.

The opposite extreme would be to take over the management of the FCS completely; to turn it into a second Farmers Home Administration (FmHA). In this way accountability for every federal dollar spent could be expected. The costs of such a strategy would be considerable, however. For example, there would be great pressure to prescribe national lending standards for what are a series of local markets (in order to provide every farmer with similar credit terms). In addition, there would be a danger of turning the FCS from a commercial entity into an instrument of social policy. Since the FmHA already fills many of the social roles that a governmentally controlled FCS might undertake, this seems redundant.

Budgetary Issues. Given the regularity with which the Congress has visited the FCS issue during the past three years, there is little inclination to pass legislation that would simply postpone the day of reckoning for the FCS for another year. But present circumstances--the size of the budget deficit, the possibility of sequestration under the Balanced Budget Act, and the spectacular growth in the agricultural budget during the last few years--all combine to put great pressure on those writing FCS legislation to minimize the budgetary impact of their bill. The upshot has been a considerable effort to move most of the cost of financial assistance off the budget, at least in the near term.

The advantage of moving the assistance package off the budget is obvious: it would reduce the need to cut other programs in order to pay for aid to the FCS. There are less obvious disadvantages to this approach, however: it would reduce still further the meaning of the budget as a statement of the cost of government, create potential future liabilities for the government, and set an unfortunate precedent for future assistance requests.

CURRENT LEGISLATIVE EFFORTS

The two major legislative vehicles for FCS assistance are H.R. 3030 and S. 1665 (a number previously attached to a bill introduced by Senators Melcher and Boren). Because the legislation is still evolving in both the House and Senate, the analysis in this report will, unless otherwise stated, be based on the texts as they stood at the end of October 1987. H.R. 3030 has already been passed by the House. As of the end of November, S. 1665 has been approved by the Senate Committee on Agriculture (but will be referred to in the remainder of this report as the "Senate bill").

Both of the bills address the three major themes identified above (system restructuring, borrowers' rights, and federal assistance) and have major areas of similarity. The bills differ in important respects, however. As regards system restructuring, the House bill goes much further than the Senate bill in authorizing, and in some cases mandating, changes in the organization of the FCS. For example, H.R. 3030 calls for the consolidation of the 36 district banks into no more than six Service Center Banks and one Bank for Cooperatives. With respect to borrowers' rights, the House bill is again more extensive, granting dispossessed borrowers the right to retain their houses and the land immediately surrounding them. Perhaps the most obvious difference between the two bills is in the way assistance is structured. The House bill authorizes the Treasury to purchase stock in the FCS in such sums as may be necessary to ensure the system's survival. The Senate bill, in contrast, authorizes the FCS to sell a special class of noncollateralized bonds. These bonds would carry a government guarantee, and assistance would be based on the amount of interest due on the bonds.

ORGANIZATION OF THE REPORT

Each of the major topics identified in this chapter will receive more extensive treatment in the chapters to follow. In Chapter II, the implications of the types of system restructuring proposed by the House and Senate bills will be discussed. The third chapter is devoted to an examination of the issues concerning the long-term supply of capital to agriculture. Chapter IV looks at the borrowers' rights provisions of the two bills. In Chapter V the many issues concerning assistance for the FCS are examined. Finally, Chapter VI looks at the overall cost of the two pieces of legislation and the difficult budgetary issues raised by the Senate proposal.

CHAPTER II

CHANGES IN THE ORGANIZATION OF THE FARM CREDIT SYSTEM

Current discussion of changes in the organization of the FCS focuses on two central topics:

- The operating efficiency of the system; and
- Borrower stock purchase requirements.

Proposals to improve operating efficiency have concentrated on consolidating functions and reorganizing responsibilities within the system. As an example of consolidating functions, both the House and the Senate bills would authorize the merging of Production Credit Associations and Federal Land Bank Associations so that both operating and real estate loans could be obtained from one office. In addition to improving efficiency, an underlying motivation for reorganizing responsibilities within the FCS is to increase the degree of local control over lending decisions.

Changes in borrower stock purchase requirements would affect the system's capital stock and could alter the cooperative character of the FCS. The immediate question regarding borrower stock purchase requirements is the degree to which borrowers should be held financially responsible for the financial problems of the FCS.

SYSTEM RESTRUCTURING

As shown in Figure 1, the FCS is a complex, three-tiered, cooperative. The first tier is composed of the approximately 150 Production Credit Associations (PCAs) and the 230 Federal Land Bank Associations (FLBAs). The principal function of PCAs is to provide short-term and intermediate-term loans for the production, processing, and market-

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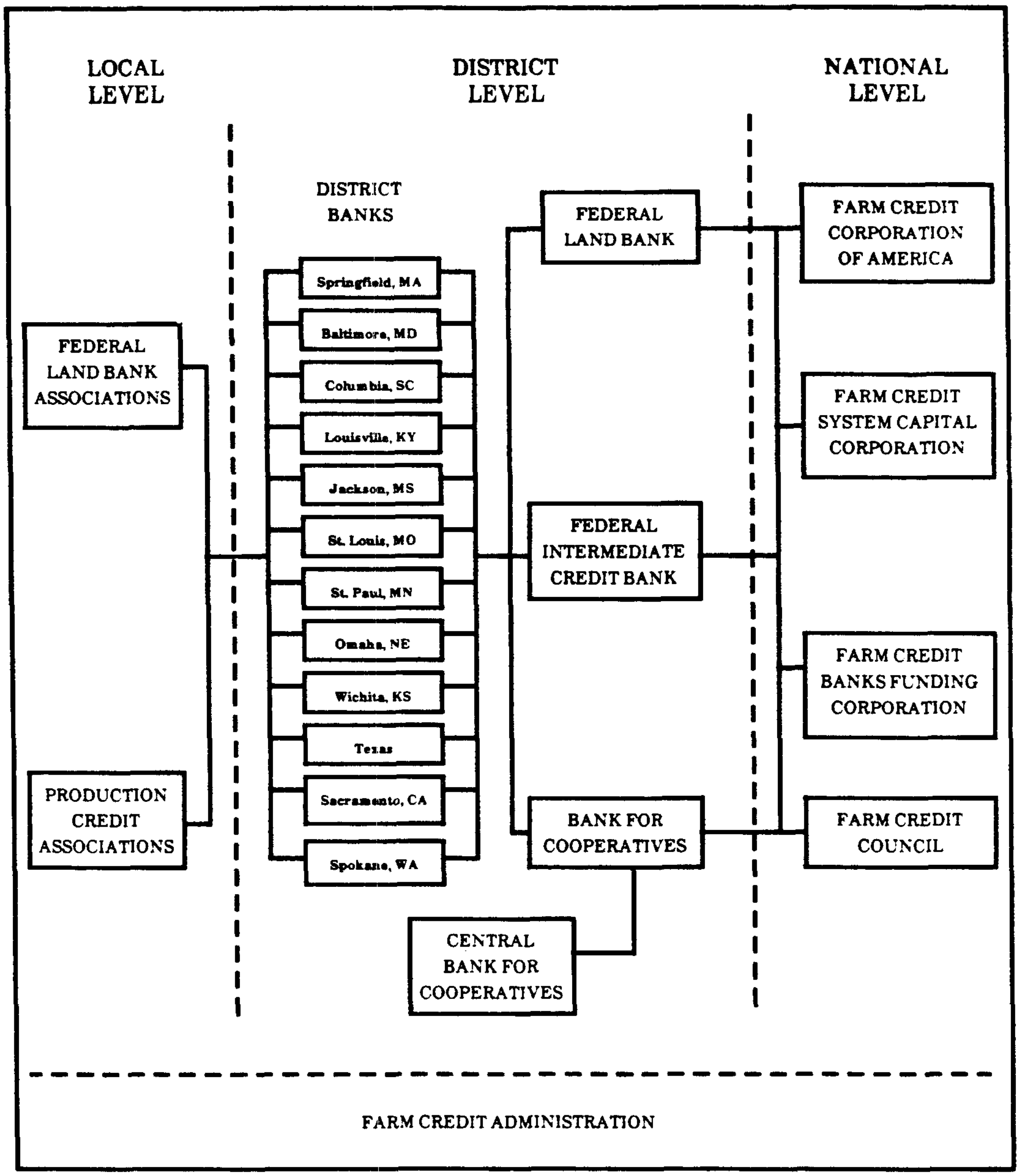
FIGURE 1. ORGANIZATION OF THE FARM CREDIT SYSTEM



SOURCE: Congressional Budget Office.

ing of agricultural products. *FLBAs are the conduit through which the* FCS provides long-term financing for the purchase of agricultural land, equipment, and other long-lived assets.

The second tier consists of the Banks for Cooperatives (BCs), the Central Bank for Cooperatives, the Federal Intermediate Credit Banks (FICBs), and the Federal Land Banks (FLBs). Each of the 12 districts in the FCS has a BC, an FICB, and an FLB. The BCs lend to agricultural cooperatives involved in all aspects of the food production and distribution system. FICBs provide short- and intermediate-term credit, principally to the local PCAs in their districts. The FLBs make long-term loans secured by first liens on real estate to agricultural producers using the local FLBAs.

The final tier is composed of organizations that function at the national level. The Farm Credit Corporation of America is the principal policymaking body in the system and is responsible for implementing management and accounting procedures. The Farm Credit System Capital Corporation was created by the 1985 Farm Credit Act to provide assistance to financially stressed banks and associations within the FCS. The Federal Farm Credit Banks Funding Corporation sells system securities in national capital markets in order to generate the loanable funds needed by the system. The Farm Credit Council is an independent trade association that represents the interests of the FCS before the Congress and the Administration. The FCS also has an entity that offers leasing services. Finally, the Farm Credit Administration is the governmental agency responsible for regulating the FCS to ensure its safety and soundness.

The complexity of this structure has raised questions about the operating efficiency of the system, and about the relationships between the various parts of the FCS.

Operating Efficiency

Some critics suggest that the multilevel structure of the FCS is inefficient. One measure of operating efficiency might be a firm's return on assets (implying that if a firm was inefficient, it could not maintain a "normal" rate of return). Indeed, as shown in Table 1, the system's return on assets was relatively low in the early 1980s and has been negative during the past two years. But since cooperatives are borrower-owned and borrower-operated, they function somewhat differently than private firms. In a cooperative, profits in excess of the capital needs of the business are returned to the members as patronage refunds. Given the circularity of this transaction, the cooperative has an incentive to maintain a low profit margin (and hence, a low return on assets). For this reason, measures of profitability may not be the best gauge of the efficiency of a cooperative.

Another measure of efficiency might be operating expenses relative to gross loan volume, suggesting that the lower the ratio the more efficient the delivery of credit. Table 1 shows that net expenses from operations (operating expenses less other income) as a percentage of total loans has increased quite significantly during the 1980s, going from 0.3 percent in 1981 to 1.5 percent in 1986.

TABLE 1. SELECTED MEASURES OF FCS PERFORMANCE

	1981	1982	1983	1984	1985	1986
Total Loans (in billions of dollars)	78.7	81.4	81.9	79.8	69.8	58.2
Return on Average Assets (percent)	1.2	1.3	0.6	0.4	-3.4	-2.6
Net Expenses/ Total Loans (percent)	0.3	0.5	0.8	0.9	1.5	1.5
Allowance for Loan Loss/ Total Loans (percent)	1.8	1.8	1.7	1.7	4.6	6.2

SOURCE: Congressional Budget Office, from FCS annual reports.

However, if an institution has a relatively large volume of nonaccrual and other high-risk loans, an increase in operating expenses per dollar loaned would be expected. Such loans require much greater servicing efforts and result in higher overhead. One measure of a lender's perception of the relative riskiness of its portfolio is loan loss reserves as a percentage of total loans. Table 1 indicates that this ratio was quite stable until 1984 but has increased substantially since that time. Thus, at least a portion of the increase in operating expenses relative to loan volume is explained by the increased riskiness of the FCS portfolio.

In sum, there are legitimate concerns about the operating efficiency of the FCS. The importance of controlling operating expenses will be discussed below. But while the concern is justified, the correct performance measures of the system's operating efficiency are not obvious.

Local Control

Concern about the relationship among the various levels of the FCS focuses mainly on the degree of local control in the system. Increasing local control means that Production Credit Associations (PCAs) and Federal Land Bank Associations (FLBAs) would be given much greater latitude in determining lending policies, making fund-raising decisions, and establishing other aspects of daily operations. Currently, district banks make most of the decisions about bond sales to raise funds, the terms on loans, and operating procedures.

Advocates of increased local control argue that this would improve the ability of the FCS to serve its farmer-borrowers. One of the original goals of the FCS was to increase the control that farmers have over their supply of credit. Local participation in the decisions regarding loan applications and other aspects of the cooperative's business is an important factor in providing farmers with this control.

But increasing local control could undermine the national character of the FCS and conflict with the goal of increasing operating efficiency. The FCS is supposed to be a system, with shared interests and responsibilities. For example, one factor contributing to the ability of the FCS to raise money in capital markets at rates of interest close to those paid on Treasury bills is that bond buyers consider it to be a single entity. Joint and several liability--the clause that states that each system bank can be held financially responsible for the notes and bonds issued by all other banks--binds the FCS together and permits it to diversify geographically the risk associated with agriculture. Furthermore, as long as the FCS is considered to be a single entity, investors who purchase its bonds need only consider the financial condition of the system as a whole. If the unity of the FCS came into question, investors would have to examine the financial condition of the individual banks and associations participating in a given offering of FCS bonds. In addition to increasing the riskiness of FCS investments, such a change would increase the transaction costs for bond buyers by a substantial amount.

While an increase in local control would not inevitably and directly erode the cooperative character of the system, excessive decentralization could do so. For example, suppose a local association is given responsibility for all decisions regarding loans, bond sales on its behalf, and the distribution of its capital. Over a number of years it proves itself to be a prudent manager of its affairs, and prospers. It is then instructed to part with some of its capital in order to assist a local association in another state. It may never have heard of the other association, not know why it is having financial difficulties, and not know what measures have been taken to deal with the problems. It is an open question whether the financially sound association would comply with this capital assessment without seeking a release, presumably through the courts.

System Restructuring in Current Legislation

The Senate and House bills propose similar forms of system restructuring. Currently, some districts allow mergers between unlike associations (PCAs and FLBAs). Both bills would authorize these local mergers in all districts, permit mergers between banks at the district level--for example, between a Federal Land Bank (FLB) and a Federal Intermediate Credit Bank (FICB)--and allow associations and banks to join. Mergers would have to be approved by the Farm Credit Administration (FCA), a majority of stockholders (the farmer-borrowers), and the relevant boards of directors. The House bill requires the appointment of non-FCS personnel to the boards of directors of the various system entities. These outside directors should provide a broader range of opinions when questions of system policy are being discussed.

There are some differences between the two bills with respect to system restructuring. For instance, in the Senate bill the FCS is authorized to charge origination fees. These fees are designed to offset in part the capital that would be used if borrower stock purchase requirements (to be discussed in the next section) are reduced or eliminated. The House bill makes no mention of origination fees. Undoubtedly the biggest difference between the two pieces of legislation is contained in Title 4 of the House bill. In this title, the FLBs and FICBs are required to apportion their assets, liabilities, and capital to the FLBAs and PCAs in their districts. District banks would be eliminated in the House bill. In their place, the House bill creates no more than six Service Center Banks. The Service Center Banks are proscribed from establishing loan pricing or approval policies and are to concentrate on providing such services as accounting, coordination of funding requests, and other unspecified "non-lending and non-management services" at the request of the associations.

Implications of System Restructuring

The underlying question regarding the need for organizational change in the FCS concerns the extent to which current financial difficulties are the result of operating inefficiencies. While it is difficult to apportion responsibility for the financial difficulties facing the FCS among the various contributing factors, much of it must be assigned to general economic factors and to less than perfect foresight. Few predicted the concerted effort made by the Federal Reserve Board to bring inflation under control, the dramatic increase in the value of the dollar, the fall in U.S. agricultural exports, the global economic slowdown, and the fall in agricultural land values. If macroeconomic events are the preeminent factor in explaining the system's current state of affairs, it is unlikely that changes in its structure will significantly improve its performance.

To be sure, the system acted in ways that, in retrospect, exacerbated its financial difficulties. For example, raising lending limits (to 85 percent of the market value of the underlying collateral), basing loan decisions on collateral values rather than the income-generating capacity of the land, and use of average cost pricing for loans all contributed to the system's current financial woes. However, with the exception of the use of average-cost pricing, other lenders in agriculture committed similar mistakes. The FCS, in general, did things the way other agricultural lenders were doing them but did more lending than others. Hence its problem is greater in magnitude.

The foregoing discussion is not meant to deprecate efforts to control expenses within the FCS. One indication of the importance of reducing system costs can be seen in the following comparison. In this paper's base-case estimate of the FCS's financial condition, operating expenses were assumed to fall by 5 percent per year. That scenario meant that $2.8 billion in assistance would be required to avoid borrower stock impairment. If operating expenses are assumed to remain at 1986 levels for the duration of the projection period, total assistance needed increases to $3.1 billion for the five-year period. Thus, controlling operating expenses is an important variable in determining the amount of assistance that the system will require, although this alone cannot return the system to profitability.

Impact of Mergers on the System. Expanding the authority to merge institutions within the FCS could have several beneficial consequences. Heretofore, the PCA/FICB, FLBA/FLB, and the Bank for Cooperatives (BC) have maintained separate financial identities and frequently different managerial organizations as well. The advantages of mergers include a possible reduction in overhead, the ability to provide borrowers with a comprehensive line of services in one location, enhanced ability to mobilize internal system resources to cope with financial problems, and an additional mechanism for ousting ineffective management. Mergers could be an indirect way of liberalizing geographic restrictions on lending operations.

Opponents of the merger provisions fall into two camps. On the one hand, there are those who argue that mergers will lead to more centralized management and less local control over lending decisions. For example, if all of the associations in a district merged together, local control might be less than under the current structure.

Others argue that the rules governing mergers are so strict that they would effectively eliminate them. The rules in both bills require that a majority of stockholders in the two institutions involved, voting on the basis of one person, one vote (as opposed to voting in proportion to the amount of stock held), must approve the merger. Such a level of support might be difficult to achieve. The inability to merge could have a particularly negative impact on the associations if this precluded attaining an efficient size of operations or if changes in banking laws enhanced the competitive position of other lenders (for example, by liberalizing the laws covering branch banking and multibank holding companies). In the short term, the very different financial conditions of the PCAs and the FLBs could make achieving majority votes for mergers even more difficult.

Title IV of H.R. 3030, as noted, goes a step beyond defining the rules for mergers by dismantling the district banks and creating Service Center Banks. Several consequences of this change should be considered. First, such a devolution of authority and responsibility would make failure of system institutions more acceptable from both the political and economic viewpoints. The district banks are multibillion-dollar institutions. A failure of a district bank could have significant, negative repercussions for the system and, conceivably, for capital markets more generally. In contrast, the failure of an association might have a significant impact on its local area but would be unlikely to foster additional uncertainty in national markets. Second, this change could also increase the probability of failure for system institutions. Local associations might not, for example, have the training and personnel to raise capital in the bond market efficiently. To the extent that this would increase the cost of funds for an association, its competitive position vis a vis other lenders would be eroded.

A third potential implication of the structural change called for in Title IV of H.R. 3030 concerns the relationship between the individual associations and the FCA. Currently, the district banks and the Farm Credit Corporation of America (FCCA) act as a sort of buffer between the associations and the FCA. Downgrading the power and status of the district banks would reduce the effectiveness of this buffer. The FCA has, in the past, been more than an arm's-length regulator by playing an active management role, for example, in approving or disapproving interest rates charged by banks or associations. To the extent that the FCA was given responsibility for overseeing the expenditure of government funds in an assistance package, the line between regulator and manager would become more blurred. As the sole regulator of a relatively large number of associations, the FCA might come to dominate the relationship, and thereby reduce the true extent of local control.

Budget Impacts of Restructuring. Because of the importance of macroeconomic factors in explaing the current financial problems of the FCS, changing its structure would not have a major impact on the cost of either the House or the Senate bill. This study estimates the efficiency gains from system restructuring under the House bill at $100 million over five years. Because the structure of assistance in the Senate bill is so different, a direct comparison of its system restructuring costs with those of H.R. 3030 is somewhat misleading (more will be said on this point in the chapter that discusses the assistance packages offered in the two bills). Given this precaution, the study estimates that system restructuring under the Senate bill would reduce assistance by perhaps $10 million over five years.

CHANGES IN BORROWER STOCK

The FCS is said to be a borrower-owned cooperative. Ownership is expressed through the purchase of borrower stock. Currently, when a loan is obtained from the FCS the borrower is required to purchase stock in the system. The amount of stock required is between 5 percent and 10 percent of the value of the loan obtained, and is included in the loan. For example, if a farmer wanted to borrow $100,000 from the FCS with a 10 percent borrower stock requirement, the size of the loan, if granted, would be $110,000. The interest would be paid on the full $110,000 borrowed.

Holding stock entitles the borrower to vote for candidates to the cooperative's board of directors and to a share of any patronage dividends issued by the institution. Stock is retired when the loan is repaid (in the above case, when the $100,000 is repaid). Historically, redemption has usually been at par, and borrower stock has not been viewed as a risky investment.

Two issues are involved in the debate over whether borrower-owners should shoulder any responsibility for the system's financial troubles. Borrowers from the FCS are loosely analogous to stockholders in a corporation in that both own equity shares in the institution. When a corporation fails, the shareholders receive only what is left after the creditors are satisfied. In short, their equity is at risk. A case can therefore be made that the holders of borrower stock should bear some of the cost of the FCS's financial difficulties. But there are two general arguments against holding borrowers financially responsible for the FCS's problems. First, since borrowers do not purchase stock voluntarily, they are not investors who have chosen to bear the risk associated with ownership. Second, the costless redemption of borrower stock is part of borrowers' expectations, and the risk of losing equity in the system would lead to more borrower flight and to greater difficulty in attracting customers for new loans, thus making the financial prospects of the system worse.

Borrower Stock Requirements in Current Legislation

Both the House and the Senate bills would reduce required borrower stock purchases on loans obtained five years after enactment--to one share of voting stock in the House bill and to voting stock equal to the lesser of 2 percent of the value of the loan or $1,000 in the Senate bill. The two bills treat existing borrower stock somewhat differently. In the House bill, existing stock can either be converted to new, at-risk stock, or can be redeemed to reduce outstanding debt. In the Senate's version, a portion of borrower stock must be converted to voting stock, and minimum or maximum stock purchases need not be required on new loans. Both measures guarantee redemption of borrower stock at par for the first five years after the bill is signed into law.

Impact on the System. Eliminating the stock purchase requirement would have several advantages. First, a significant political advantage is that its elimination would remove a major source of constituent complaints about the system. If farmer-borrower/voters did not have capital at risk, the failure of a system entity would be of less political significance. Second, elimination of the stock purchase requirement would force the system to report more accurately its capital position. Heretofore, borrower stock has been treated as system capital, even though few considered it to be truly at-risk equity. Treating current borrower stock as system capital significantly overstates the equity base in the FCS. Third, elimination of the requirement would facilitate the comparison of borrowing costs across lenders.

One disadvantage of eliminating borrower stock would be the potential impact on the functioning of a cooperative. In general, cooperatives have three distinct centers of power: the general membership, the board of directors, and the management. The general membership elects the board of directors who, in turn, hire and fire the team that manages the day-to-day business of the cooperative. To the extent that the members or the board of directors lose interest in the cooperative, an important oversight function is lost. The concern of those who would retain the borrower stock requirement is that the absence of a financial stake in the cooperative would diminish borrower participation in its affairs.

A second concern is that elimination of borrower stock requirements, along with other changes proposed by these bills, would change the character of the FCS. One of the salient characteristics of a cooperative is ownership by its patrons. Elimination of borrower stock would break this link. Further, creation of a new class of at-risk stock that would be offered to any interested investor would increase the similarity between the FCS and any large commercial bank. Finally, changes in the loan pricing policies followed by the FCS, in which financially stronger borrowers would receive a lower interest rate, would violate one tenet of the cooperative movement--the equal treatment of all members. (It should be noted that the Senate bill restricts the ability of FCS institutions to practice differential pricing.) Many of the benefits granted to the FCS under agency status were given because of its cooperative characteristics, and might not be appropriate if the FCS became a national agricultural bank.

Budget Impacts. Given the provisions of the House bill, virtually all borrowers could be expected to reduce their debt rather than convert existing stock to at-risk stock. This conclusion is based on the uncertain returns that would be associated with the new, at-risk stock. Redemption of stock would reduce the system's capital and its level of interest-earning loans. Thus, changing the treatment of borrower stock could be expected to increase the cost of the House bill by about $300 million over the next five years. In S. 1665, it is assumed that no new borrower stock would be issued except in the form of voting stock. As a result, this study estimates that changing borrower stock requirements would increase the cost of S. 1665 by about $25 million during the next five years.

CHAPTER III

LONGER-TERM FINANCIAL ISSUES

Operating losses during the past two and a half years have depleted most of the FCS's earned surplus. In addition, the changes in borrower stock requirements proposed by the House and Senate bills--discussed in the preceding chapter--would contribute to a continuing drain on the system's capital resources. Low levels of capital reduce the ability of the system to cope with the cyclical downturns to which the agricultural sector is prone. Because its capital resources are at a low level, there is some concern about the long-term viability of the FCS. The failure of all or a major part of the FCS would have significant negative repercussions for the supply of credit to agriculture.

The House and Senate bills address the issue of the agricultural sector's long-term supply of credit in two, potentially contradictory, ways: enhancing access to national capital markets and expanding the ability of the FCS to withstand financial shocks. One measure designed to ensure agriculture's access to national capital markets is a secondary mortgage market. Enhancing the longer-term viability of the FCS requires weighing alternative risk management strategies for the system--for example, establishing minimum capital requirements and an insurance fund.

SECONDARY MORTGAGE MARKETS

Secondary mortgage markets work as follows. The lender who makes the loan, typically called the originator, retains responsibility for a portion of the loan (10 percent, for example), and sells the remainder to an institution that bundles groups of loans into pools (known as the pooler). The 10 percent held by the originator is designed to deter originators from making poor-quality loans; the originator's investment is the first source of funds tapped in the case of default.

A pooler then provides the service of bundling together numerous relatively small loans. Pools reduce the transaction costs associated with selling bonds backed by these mortgages. In addition, to the extent that the individuals who took out the mortgages have different sources of income, pooling would reduce the aggregate risk. The pooler profits from a spread between the rates charged by the originator and those on the secondary market.

The seller of these mortgage-backed bonds provides "credit enhancement," which is essentially an assurance that interest and principal will be paid. This credit enhancement may be backed by privately acquired insurance or, as in the case of the FCS and other agency lenders, by an implied link to the federal government. The more direct and explicit the link to the government, the lower the interest rate associated with these securities.

Proponents of secondary markets for agricultural mortgages cite several advantages. First, agricultural real estate loans are long-term, relatively illiquid loans that some lenders are reluctant to make. Those in favor of secondary markets argue that by enabling lenders to sell a large part of these loans, the secondary market might increase the participation of non-FCS lenders, such as commercial banks, in this market. Many feel that the FCS, with nearly 40 percent of the agricultural real estate market, has become too dominant, and that a secondary market would increase the ability of other lenders to compete for these loans. Increasing competition in this portion of the agricultural credit market would benefit farmers. It is also suggested that in addition to shifting market shares, a secondary market might increase the total supply of credit available to the sector. Finally, such a market would enable a portion of the risk associated with financing agriculture to be transferred to the nonagricultural sector, in this case to the buyer of bonds backed by agricultural mortgages.

The major drawback associated with a secondary market for agricultural mortgages is that it would be unlikely to generate a large volume of business. First, agriculture already has a type of secondary market for agricultural loans in the FCS. Whether or not the secondary markets described in the House and Senate bills would be in direct competition with the FCS is unclear. Nevertheless, though the FCS only pools loans from other lenders in a very limited sense, and their securities are not explicitly backed by mortgages, it does